

No. 16395

United States
Court of Appeals
for the Ninth Circuit

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,
vs.
J. I. MORGAN and FRANCES MORGAN,
Respondents.

Transcript of Record

FILED

MAY -5 1959

PAUL P. O'BRIEN, CLERK

Petition to Review a Decision of the Tax Court
of the United States

No. 16395

United States
Court of Appeals
for the Ninth Circuit

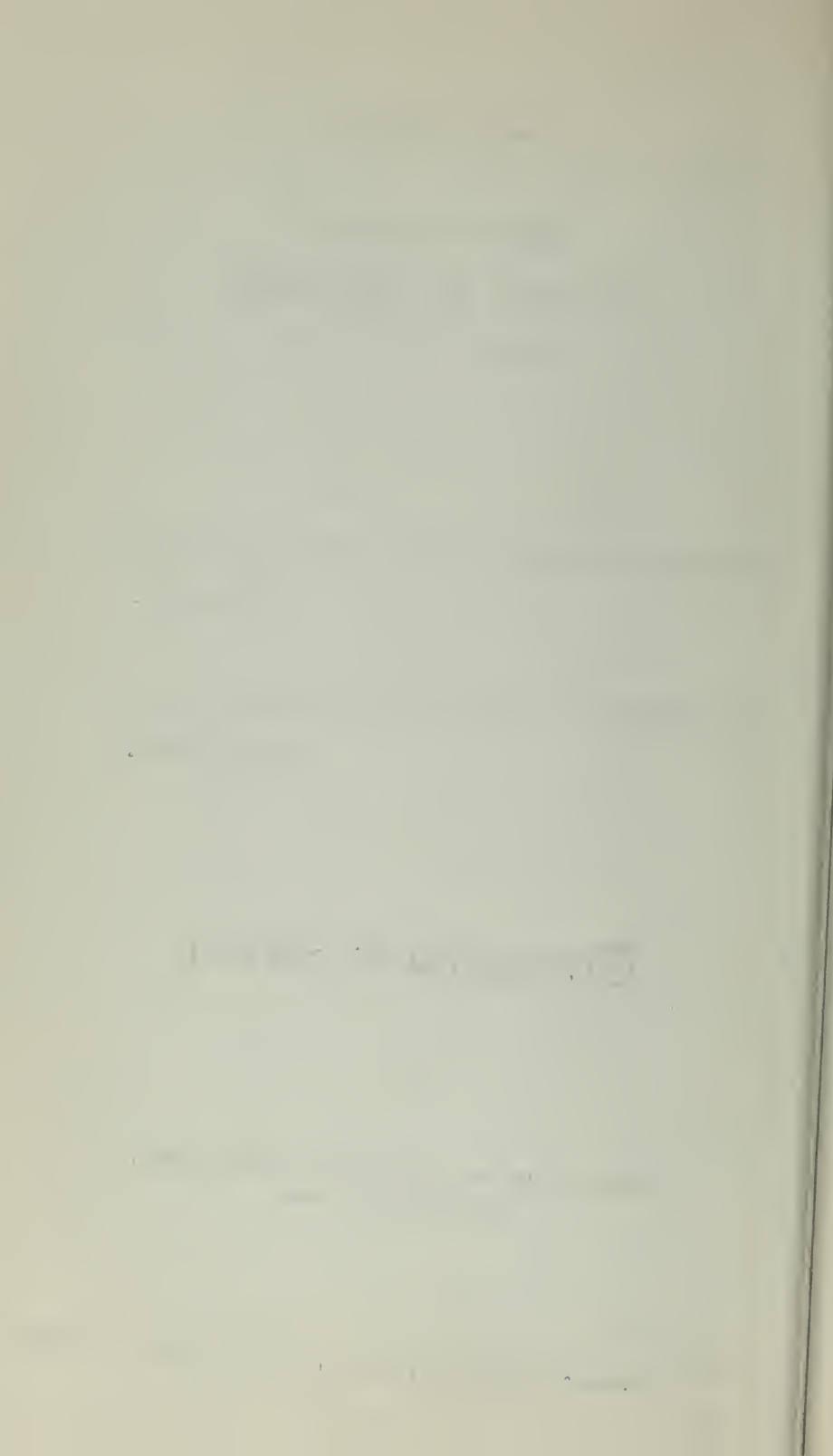
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[Clerk's Note: When deemed likely to be of an important nature, errors or doubtful matters appearing in the original certified record are printed literally in *italic*; and, likewise, cancelled matter appearing in the original certified record is printed and cancelled herein accordingly. When possible, an omission from the text is indicated by printing in *italic* the two words between which the omission seems to occur.]

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APPEARANCES

CHARLES K. RICE,

Asst. U. S. Attorney General,
Tax Division, Dept. of Justice,
Washington 25, D. C.,

For the Petitioner.

CARL E. DAVIDSON,

CHARLES P. DURRY,

1525 Yeon Bldg.,
Portland, Oregon,

For the Respondent.



Tax Court of the United States

Docket No. 61346

J. I. MORGAN AND FRANCES MORGAN,
Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

DOCKET ENTRIES

1956

Mar. 12—Petition received and filed. Taxpayer notified. Fee paid.

Mar. 13—Copy of petition served on General Counsel.

Mar. 12—Request for Circuit hearing in Portland, Oregon, filed by taxpayer. Granted 3/13/56.

Apr. 26—Answer filed by respondent. Served 5/3/56.

Nov. 26—Hearing set 2/18/57—Portland, Oregon.

1957

Feb. 4—Notice of change of trial date to 2/19/57, Portland, Oregon.

Feb. 22—Trial had before Judge Withey on merits and petitioners' motion to consolidate with 61345. Motion granted. Motion (served) and Stip. of Facts filed at hearing. Briefs due 5/23/57; Replies due 6/22/57.

Mar. 18—Transcript of Hearing 2/22/57 filed.

May 6—Brief for Petrs. filed. Served 8/2/57.

1957

- May 21—Motion for extension of time to July 23, 1957, to file brief, filed by respondent. Granted 5/22/57. Served 5/23/57.
- July 22—Motion for extension of time to July 31, 1957, to file brief, filed by respondent. Granted 7/23/57.
- July 25—Motion served.
- July 31—Brief for Respondent filed. Served 8/2/57.
- Aug. 27—Motion by respondent for extension of time to September 9, 1957, to file reply brief. Granted 8/29/57. Served 9/3/57.
- Aug. 27—Reply Brief for Petitioners filed.
- Sept. 9—Reply Brief for Respondent filed. Served 9/11/57.

1958

- July 9—Findings of Fact and Opinion filed, Judge Withey. Dec. will be under R. 50.
- Sept. 18—Agreed computation, Rule 50, filed.
- Sept. 23—Decision entered, Judge Withey.
- Dec. 11—Petition for review by U. S. C. A. 9th Circuit, filed by respondent.
- Dec. 23—Proof of service of petition for review (sent counsel) filed.
- Dec. 23—Proof of service of petition for review, Taxpayer (Frances Morgan), filed.
- Dec. 23—Proof of service of petition for review, Taxpayer (J. I. Morgan), filed.

1959

- Jan. 12—Motion for extension of time to March 11, 1959, to file record on review and docket petition for review filed by respondent.

1959

Jan. 13—Order, enlarging time to file record on review and docket petition for review to March 11, 1959. Served 1/14/59.

Feb. 12—Designation of contents of record on review, with proof of service thereon, filed.

Feb. 20—Proof of service of designation of contents of record on review, filed.

[Title of Tax Court and Cause.]

Docket Nos. 61345, 61346

FINDINGS OF FACT AND OPINION

1. Petitioner corporation acquired assets from its majority stockholder pursuant to an installment sales contract under the terms of which the consideration was to be paid in 7 annual installments. Title to the assets was reserved in the transferors until the full purchase price was paid. Held:

(a) That the transaction by which the assets were conveyed to the corporation was a sale and not an exchange of assets for stock within the meaning of section 112(b) (5), I.R.C. 1939, and the gain realized by the transferors is recognized.

(b) That the basis to the transferee corporation of the assets acquired by it is the cost of the assets. Section 113(a), I.R.C. 1939.

(c) That the corporation is entitled to deductions for interest paid to the transferors pursuant to the installment sales contract.

(d) That the payments of principal and interest received by J. I. Morgan from the corporation pursuant to the installment sales contract do not constitute a distribution of dividends.

2. The annual increment in the cash value of an "Accumulative Investment Certificate" held not taxable as ordinary income during the years in issue but taxable only as capital gain upon retirement at maturity. *George Peck Caulkins*, 1 T. C. 656, *affd.* 144 F. 2d 482, followed.

Appearances:

CARL E. DAVIDSON, ESQ., and
CHARLES P. DUFFY, ESQ.,
For the Petitioners.

JOHN D. PICCO, ESQ.,
For the Respondent.

Withey, Judge:

The respondent determined deficiencies in petitioners' income tax for the years and in the amounts as follows:

Name	Docket No.	Fiscal year ended	Deficiency
		April 30	
J. I. Morgan, Inc.	61345	1952	\$11,601.55
		1953	60,872.75
		1954	56,610.97
J. I. Morgan and Frances Morgan	61346	1950	4,512.22
		1951	2,122.29
		1952	10,141.54
		1953	16,618.28
		1954	3,305.34

The issues presented for our determination are the correctness of the respondent's action (1) in determining that the acquisition of assets by the petitioner J. I. Morgan, Inc., in exchange for an installment contract constituted a nontaxable exchange of property for stock within the meaning of section 112(b)(5) of the Internal Revenue Code of 1939; (2) in determining that the assets acquired by J. I. Morgan, Inc., retain the same basis as they had in the hands of the transferors prior to the transfer; (3) in disallowing the deductions claimed by J. I. Morgan, Inc., for interest paid to J. I. Morgan pursuant to an installment contract; (4) in determining that petitioner J. I. Morgan received dividend distributions under the guise of payments of principal and interest from J. I. Morgan, Inc.; and (5) in determining that the increment in value of an "Accumulative Investment Certificate" is in the nature of interest and constitutes ordinary income to J. I. Morgan.

General Findings of Fact

Some of the facts have been stipulated and are found accordingly.

Petitioners J. I. Morgan and Frances Morgan are husband and wife residing at New Meadows, Idaho. They filed their joint income tax returns for 1950, 1951, 1952, 1953 and 1954 with the director of internal revenue for the district of Idaho. They kept their books of account and prepared their income tax returns on an accrual basis.

Petitioner J. I. Morgan, Inc. (sometimes hereinafter referred to as the corporation), is a corporation organized under the laws of the State of Idaho with its principal office located at New Meadows, Idaho. The corporation filed its income tax returns for 1952, 1953 and 1954 with the director of internal revenue for the district of Idaho. J. I. Morgan, Inc., kept its books of account and prepared its income tax returns on an accrual basis.

Issues 1, 2, 3 and 4.—Sale or Exchange Under Section 112(b) (5), I.R.C. 1939, and Related Issues.

Findings of Fact

For several years prior to 1946, J. I. Morgan was employed by the Boise Payette Lumber Company (sometimes hereinafter referred to as Boise Payette or the company) as its logging superintendent and master mechanic. He became dissatisfied with his employment in this capacity but Boise Payette desired to have him continue the logging of its timber. As a result, a written agreement, dated April 1, 1946, was executed by Boise Payette and Morgan, by the terms of which the latter agreed to log timber for the company as an independent contractor.

At the time of the execution of the agreement, Boise Payette and Morgan entered into a separate contract whereby Boise Payette agreed to sell Morgan its logging equipment, together with certain buildings and other property, for a total purchase price of \$234,685.05. The logging equipment con-

stituted substantially all of the equipment which the company theretofore had used in its logging operations. The purchase price (equivalent to Boise Payette's book value plus 20 per cent) was to be paid by charges against the operating account of J. I. Morgan at the rate of \$1.75 per 1,000 feet of logs produced by Morgan's logging operations. No interest was payable on the deferred balance. The contract was fully performed and title to the land and equipment was transferred to Morgan on or about March 21, 1950. Upon execution of the contract, Morgan's operating account with the company was charged with additional items amounting to \$109,647.84, making a total cost to J. I. Morgan of \$344,332.89. After April 1, 1946, the logging operations for Boise Payette Lumber Company were conducted by Morgan as sole proprietor, with Edward N. Morgan employed as equipment foreman and Edward S. Millspaugh employed as logging superintendent. Edward N. Morgan and Edward S. Millspaugh were compensated at an agreed rate based on the number of feet of logs produced. In the spring of 1950, however, an arrangement was made whereby J. I. Morgan was to receive 60 per cent of the net income of the logging operations and Edward N. Morgan and Millspaugh were each to receive 20 per cent of net income.

J. I. Morgan, Edward N. Morgan and Millspaugh had worked together for a number of years and J. I. Morgan had developed great confidence in their ability and desired to retain their services.

However, Edward N. Morgan and Millspaugh were not satisfied to continue as employees of J. I. Morgan and demanded a proprietary interest in the business.

J. I. Morgan, Inc., was incorporated under the laws of the State of Idaho on November 29, 1948, with an authorized issue of common capital stock of 2,500 shares at a par value of \$100 each. Until June 1, 1950, only 3 shares of stock in J. I. Morgan, Inc., were subscribed—one each by J. I. Morgan, Frances Morgan and Edward N. Morgan. The corporation was inactive until after October 1, 1950.

On June 5, 1950, a special meeting of the board of directors of J. I. Morgan, Inc., was held for the purpose of discussing the advisability of subscribing for additional capital stock of the corporation in the amount of \$10,000. The directors were J. I. Morgan, Frances C. Morgan and Edward N. Morgan. J. I. Morgan indicated a willingness to subscribe for \$6,000 worth of stock of the corporation and Edward N. Morgan and Millspaugh each agreed to subscribe for \$2,000 worth of the corporation stock. Consequently, resolutions were adopted by the directors authorizing J. I. Morgan, Inc., to issue and deliver 59 shares of the capital stock of the corporation to J. I. Morgan, 1 share to Frances Morgan and 20 shares each to Edward N. Morgan and Edward S. Millspaugh in consideration of \$100 per share. The capital stock of the corporation was paid for on or about October 1, 1950, at which time it was issued and delivered in accordance with the corporate

resolution. The remaining 2,400 shares of the capital stock remain unsubscribed. Edward N. Morgan and Millspaugh were agreeable to continuing as 20 per cent stockholders in J. I. Morgan, Inc., but they were unwilling to accept a smaller proportionate interest therein.

The stockholders discussed the possibility of expanding the operations of the corporation by engaging in road construction, land clearing and the milling of jack pine, but they eventually rejected those suggestions. J. I. Morgan also contemplated leasing to the corporation his logging equipment but the idea finally was abandoned. The initial capital investment in the amount of \$10,000 would have been sufficient to enable the corporation to continue its operations in the event the directors had decided to rent the logging equipment of J. I. Morgan.

After deciding to sell the logging equipment to the corporation, J. I. Morgan and Frances Morgan submitted a written offer to the corporation to sell to it certain real and personal property, including logging equipment, for \$500,000, together with the assumption by the corporation of certain of the liabilities of J. I. Morgan in the amount of \$129,682.55. The offer was accepted by the directors of J. I. Morgan, Inc., on September 25, 1950.

On or about October 1, 1950, J. I. Morgan and Frances C. Morgan executed a written contract of sale with J. I. Morgan, Inc., pursuant to which they

sold certain real estate, logging equipment, machine shop equipment, office equipment, and other personal property to the corporation. The contract provided, in part, as follows:

It is expressly and specifically agreed that title to said property, or any part thereof, or any additions thereto or improvements thereon, shall not pass from the Sellers to the Purchaser until the entire purchase price shall have been paid in full, and that no right, title or interest, legal or equitable, in the property aforesaid, or any part thereof, shall vest in the Purchaser until the delivery of the deed and bill of sale by the Sellers, or until the payment of its purchase price in full, and at the times and in the manner herein provided.

The contract called for fixed payments to be made to the transferors without regard to the earnings of the corporation. No agreement was made by the transferors not to enforce collection of the payments and the corporation was required at its own expense to maintain the property, to bear the risk of loss and keep the transferred assets insured for the benefit of both the buyer and seller as their interests might appear.

The adjusted basis to J. I. Morgan of the depreciable assets which were transferred by him to J. I. Morgan, Inc., on October 1, 1950, was \$177,634.69. The adjusted basis in the hands of J. I. Morgan of all the assets sold to the corporation on October 1, 1950, was \$214,377. The property

and equipment transferred to J. I. Morgan, Inc., pursuant to the contract of sale executed on October 1, 1950, had a fair market value on that date of not less than \$629,682.55.

In addition to the aforementioned property, J. I. Morgan also transferred to the corporation without additional consideration, cash in the payroll account in the amount of \$12,500; inventory of logs, \$1,000; inventory in warehouse, \$23,242.31; roads constructed at a cost of \$27,432.96; and bunk and cook houses constructed at a cost to J. I. Morgan of \$11,970.67. Further, J. I. Morgan assigned his logging contract with Boise Payette Lumber Company to J. I. Morgan, Inc., without additional consideration.

The opening journal entries on the books of the corporation as of October 1, 1950, were as follows:

(1)		Dr.	Cr.
10-1-50 Cash		\$ 10,000.00	
Capital stock			\$ 10,000.00
To record capital stock issued for cash as follows:			
J. I. Morgan....	\$ 6,000.00		
Ed Millspaugh	2,000.00		
Ed Morgan	2,000.00		
Total	\$10,000.00		

(2)

10-1-50	Cash in bank—payroll account	\$ 12,500.00	
	Accounts ¹ receivable—general	14,520.56	
	Accounts ¹ receivable—petty ledger	1,679.93	
	Inventory—logs	1,000.00	
	Inventory—warehouse	23,242.31	
	Plant, property and equip- ment	537,336.12	
	Garden Valley roads	27,432.96	
	Bunk and cook houses.....	11,970.67	
	Invoices payable :		
	Equipment	\$ 8,215.59	
	#23 Purchases ..	18,298.06	26,513.65
			<hr/>
	Costello & Miller....		6,000.00
	Payroll payable:		
	Bonuses—Ed M. & Ed M.	\$ 1,355.65)	
	—Dec. 31	6,528.75)	
	—vacation	8,368.50)	\$ 16,252.90
			<hr/>
	Boise Payette Lumber Company		77,041.49
	Accrued property taxes		3,874.51
	Note payable J. I. Morgan.....		500,000.00
	To record purchase of business from J. I. Morgan, pay- ing for same with note		

¹The receivables noted above were inserted by inadvertence. These assets actually were retained by J. I. Morgan.

The balance sheet of the corporation as of October 1, 1950, was as follows:

Assets:

Cash in bank	\$ 10,000.00
Cash in bank, payroll a/c	12,500.00
¹ Accounts receivable	14,520.56
¹ Petty ledger receivables	1,679.93
Inventory, logs	1,000.00
Inventory, warehouse	23,242.31
Plant, property, equipment	\$576,739.75
Depreciation reserve	576,739.75
	<hr/>
TOTAL	\$639,682.55
	<hr/> <hr/>

Liabilities & Capital:

Accounts payable	\$ 26,513.65
Accrued expenses payable	26,127.41
Boise Payette operating a/c payable..	77,041.49
Note and mortgage payable	500,000.00
Capital stock	10,000.00
	<hr/>
TOTAL	\$639,682.55
	<hr/> <hr/>

A down payment of \$2,000 was paid by the corporation to J. I. Morgan during 1950 on the price of the assets acquired from him. The balance due pursuant to the installment sales contract, together with interest thereon at the rate of 2 per cent per annum beginning May 1, 1951, was to be paid as follows:

¹The receivables noted above were inserted by inadvertence. These assets actually were retained by J. I. Morgan.

\$75,000.00, together with interest then due, on or before the 31st day of December, 1952; and a like sum of

\$75,000.00, together with interest on the unpaid balance, on or before the 31st day of December of the years 1953, 1954, 1955, 1956 and 1957, and the remaining balance of

\$50,000.00, together with interest due thereon, on or before the 31st day of December, 1958.

Because of the expanded logging operations and the necessity of purchasing additional equipment, J. I. Morgan agreed, pursuant to a written agreement dated December 19, 1952, to extend the time for payment of the first installment due under the contract. Thereafter, the corporation made a payment of \$30,860 on December 31, 1953, under the contract as modified, and 14 payments, aggregating \$43,123.12, from May 1, 1954, to August 31, 1955. The respondent determined that the foregoing payments for the years 1950, 1953 and 1954 constituted taxable dividends paid to petitioners J. I. Morgan and Frances Morgan. During 1954 and 1955, J. I. Morgan, Inc., also made payments on its open account with J. I. Morgan totaling \$77,876.88.

On or about July 19, 1955, a revenue agent commenced an examination of the income tax liabilities of the petitioners. During the course of his examination, the agent proposed to treat the transfer of assets from J. I. Morgan to the corporation pursuant to the installment contract as a non-

taxable exchange under the provisions of section 112(b)(5) of the 1939 Code. Consequently, after August 31, 1955, no further payments were made by the corporation pending final settlement of the present controversy.

Beginning on October 1, 1950, and continuing through the corporation's fiscal year ended April 30, 1954, J. I. Morgan, Inc., claimed deductions for depreciation in the following amounts:

Fiscal year ended April 30	Amount
1951	\$ 47,732.13
1952	174,846.57
1953	118,523.78
1954	180,943.54

J. I. Morgan, Inc., claimed deductions for interest paid to J. I. Morgan and Frances Morgan pursuant to the installment sales contract for the years and in the amounts as follows:

Fiscal year ended April 30	Amount
1952	\$9,960.00
1953	9,960.00
1954	9,277.62

The respondent determined that the foregoing payments to petitioners J. I. Morgan and Frances Morgan constituted taxable dividends. No dividends have been declared to date by J. I. Morgan, Inc.

In their joint income tax return for 1950, petitioners J. I. Morgan and Frances Morgan indicated their intention to report on the installment

basis the taxable gain realized from the transfer of assets to the corporation. They accordingly reported capital gains resulting from the foregoing transaction as follows:

Year	Amount
1950	\$ 642.73
1953	9,386.85
1954	3,864.03

J. I. Morgan, Inc., reported its net income or loss for each of the years in question, before claiming a net operating loss deduction, as follows:

Fiscal year ended April 30	Amount
1951	(\$30,198.80)
1952	(38,632.00)
1953	33,248.89
1954	22,133.16
1955	52,886.89
1956	44,556.11

The books of account of the corporation reflect the following amounts of property, plant and equipment (excluding roads) and reserves for depreciation:

	Property, plant and equipment	Reserve for depreciation
September 30, 1950	\$ 549,306.79	
Net additions	76,916.31	\$ 62,732.13
April 30, 1951	626,223.10	62,732.13
Net additions	121,824.96	98,069.59
April 30, 1952	748,048.06	160,801.72
Net additions	50,808.77	110,389.33

April 30, 1953	798,856.83	271,191.05
Net additions	166,514.20	129,384.18
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April 30, 1954	965,371.03	400,575.23
Net additions	68,046.93	149,076.14
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April 30, 1955	1,033,417.96	549,651.37
Net additions	225,001.47	143,659.10
<hr/>		
April 30, 1956	\$1,258,419.43	\$693,310.47
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In addition to making the foregoing expenditures for property, plant, and equipment, J. I. Morgan, Inc., expended substantial amounts for the construction of logging roads during the years in issue.

The corporation had the following number of employees at the end of each of the following years:

Year	Number
1950	83
1951	105
1952	121
1953	112
1954	111
1955	129
1956	135

The net profit or loss of the corporation for the taxable years 1950 through 1955, inclusive, as shown on its income tax returns for those years was as follows:

Year	Net Profit or loss
1950	(\$31,198.80)
1951	(41,032.00)
1952	(1,308.78)
1953	28,582.79
1954	52,886.89
1955	44,556.11

OPINION

The respondent has determined that the installment contract executed by J. I. Morgan and Frances C. Morgan on October 1, 1950, in fact represented equity capital; and that the acquisition of assets by the corporation in exchange for the installment contract constitutes a nontaxable exchange of property solely for stock within the meaning of section 112(b)(5) of the 1939 Code.¹ Consequently, the respondent further determined that the assets acquired by J. I. Morgan, Inc., retain the same basis as they had in the hands of

¹Sec. 112. Recognition of Gain or Loss

* * *

(b) Exchanges Solely in Kind.

* * *

(5) Transfer to corporation controlled by transferor. No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation, and immediately after the exchange such person or persons are in control of the corporation; but in the case of an exchange by two or more persons this paragraph shall apply only if the amount of the stock and securities received by each is substantially in proportion to his interest in the property prior to the exchange. Where the transferee assumes a liability of a transferor, or where the property of a transferor is transferred subject to a liability, then for the purpose only of determining whether the amount of stock or securities received by each of the transferors is in the proportion required by this paragraph, the amount of such liability (if under subsection (k) it is not to be considered as "other property or money") shall be considered as stock or securities received by such transferor.

the transferors immediately prior to the exchange under section 113(a)(8) of the 1939 Code and that the amounts paid by the corporation to the transferors were in fact dividend distributions.

Petitioners contend that the execution of the installment contract on October 1, 1950, constituted a sales transaction and created a valid debtor-creditor relationship between the transferors and the transferee corporation. The petitioners therefore contend that the gain realized on the transaction should be recognized and that the corporation is entitled to utilize the fair market value of the assets at the time of the transfer as the proper basis. Section 113(a), 1939 Code.

In support of their position the petitioners rely on our decision in *Warren H. Brown*, 27 T.C. 27. In that case the taxpayers contributed assets worth \$270,000 to a newly formed corporation and subsequently conveyed to the corporation assets valued at \$605,138.75, pursuant to an installment sales contract reserving title in the transferors until the full purchase price was paid. The business purpose underlying the execution of the installment sales contract was the refusal of one of the transferors to accept the risks attendant upon a further capital investment in the new corporation. Under local law, the reservation in the transferor of title to personal property sold under an installment sales contract created in the transferor a right to possession and ownership superior to the rights of all other creditors of the transferee. The installments

due the transferors during the years there in issue were paid by the corporation with interest thereon. Such payments were not dependent upon the earnings of the corporation.

Further, the record there did not disclose an agreement not to enforce the collection of payments from the corporation. The contract price was equal to the fair market value of the assets transferred thereunder. We there held that the transaction in question constituted a bona fide sale by the stockholder to the corporation, rather than a contribution to capital.

The factual situation involved in *Warren H. Brown, supra*, closely parallels the facts here presented, and we are of the opinion that our decision in that case is controlling here.

On October 1, 1950, J. I. Morgan and Frances C. Morgan executed an installment contract by the terms of which they agreed to sell to J. I. Morgan, Inc., certain real and personal property for \$500,000, together with the assumption by the corporation of liabilities of J. I. Morgan in the amount of \$129,682.55. Pursuant to the terms of the contract of sale, title to all of the transferred property was retained by J. I. Morgan and Frances C. Morgan until the purchase price, with interest at the rate of 2 per cent per year, is paid in full. Sixty per cent of the stock of the corporation was owned by J. I. Morgan and Frances C. Morgan, and 20 per cent of the stock was owned by Edward S. Mills-paugh and 20 per cent by Edward N. Morgan.

J. I. Morgan, Edward N. Morgan and Edward S. Millspaugh had worked together as a unit for some years, and J. I. Morgan had developed considerable confidence in the ability of Edward N. Morgan and Millspaugh and consequently desired to retain their services. However, Edward N. Morgan and Millspaugh were not satisfied to continue as employees of J. I. Morgan and demanded a proprietary interest in the business. Accordingly, if Edward N. Morgan and Millspaugh were to continue in the logging operation with J. I. Morgan, a change in the form of business appeared necessary. As a result, J. I. Morgan, Edward N. Morgan and Millspaugh made cash contributions to the corporation in the amounts of \$6,000, \$2,000, and \$2,000, respectively, in exchange for stock in the foregoing amounts.

The original capital investment in the amount of \$10,000 would have been adequate to continue the operations of the business if J. I. Morgan had leased to the corporation his logging equipment as he had at one time considered. After abandonment of the idea of leasing the logging equipment to J. I. Morgan, Inc., it became apparent that it would be necessary for the corporation to acquire the equipment if it was to continue a logging operation. If J. I. Morgan and Frances C. Morgan had contributed the logging equipment to the corporation as capital, they would have acquired 99.38 per cent of the stock of the corporation, and Edward N. Morgan and Millspaugh each would have received

only 0.31 per cent of the stock. Neither Edward N. Morgan nor Millspaugh would have consented to the acquisition of only a .31 per cent interest in the corporation. Therefore, the decision to transfer the logging equipment owned by J. I. Morgan to the corporation pursuant to an installment contract reserving title in the transferors appears clearly to have been made for an independent business purpose.

Moreover, we are convinced from the testimony of J. I. Morgan, together with the circumstances surrounding the execution of the installment contract and the transfer of the assets thereunder, that the transaction was not motivated by tax considerations. At the time of execution of the installment contract on October 1, 1950, the directors of the corporation intended to make the agreed payments to J. I. Morgan, and J. I. Morgan did not intend to waive the collection of such payments. Their intention at that time cannot be vitiated by changed circumstances or unforeseen difficulties. Although J. I. Morgan subsequently on December 19, 1952, agreed to extend the time for the corporation's payment of the first installment due under the contract because of the necessity of purchasing additional equipment to handle the expanded logging operations, the corporation thereafter on December 31, 1953, made a payment of \$30,860 and subsequently made 14 payments, totaling \$43,123.12, from May 1, 1954, to August 31, 1955.

The contract called for fixed payments to be made

to J. I. Morgan without regard to the earnings of the corporation. Further, the total price in the amount of \$629,682.55 to be paid by the corporation for the assets transferred to it pursuant to the installment contract was equal to the fair market value of the assets so transferred.

In addition, as in *Warren H. Brown, supra*, the property was not placed at the risk of the business. Under applicable Idaho law, the reservation in the transferors of title to personal property sold under an installment sales contract creates in the transferors a right of possession and ownership superior to the rights of all other creditors of the transferee. Idaho Code 1947, secs. 64-801, 64-802; *Sparkman vs. Miller-Cahoon Co.*, 282 Pac. 273. The real estate included in the contract of sale remains the property of the transferors so long as they retain record title. Idaho Code 1947, sec. 55-812.

The respondent insists that the existence here of a predominant debt structure (50 to 1 debt-stock ratio) on the part of the corporation places the petitioners in an untenable position. However, we are unable to accept the proposition that this capitalization standing alone is sufficient to justify the treatment of an installment sales contract as evidence of equity capital. See *Sheldon Tauber*, 24 T.C. 179; *Harry F. Shannon*, 29 T.C. . . . (Jan. 28, 1958). Further, the capitalization of the corporation does not appear to have been inadequate. Although it sustained losses during the first three

years of its operation, during 1953, 1954 and 1955, its net profits as disclosed on its Federal income tax returns amounted to \$28,582.79, \$52,886.89 and \$44,556.11, respectively. Throughout the period 1950-1955, the corporation expended substantial sums in acquiring additional property, equipment, and plant facilities, and in the construction of logging roads. In addition, it increased the number of its employees from 83 at the end of 1950 to 135 at the end of 1956. There is no indication in the record that J. I. Morgan, Inc., acquired additional funds either through debt or equity financing after commencing operations in 1950, nor is there evidence of any attempt to do so.

Petitioner's ability to conduct its operations with small capital is accounted for at least in part by the fact that its principal asset, outside of its logging equipment, was a contract with Boise Payette Lumber Company to perform all of its logging operations. Aside from the fact that the record discloses a long and friendly relationship between J. I. Morgan and Boise Payette, it is further apparent that the latter company desired to divest itself of its logging operations and to retain the services of J. I. Morgan as an independent contractor to perform the function. It seems clear that it was to the best interest of Boise Payette, from that standpoint, and from the further standpoint that it was Morgan's principal creditor, to further the business enterprise of the corporation and to do whatever was necessary to prevent it from falling into financial difficulties.

The respondent relies heavily on our decision in *Gooding Amusement Company*, 23 T.C. 408, *affd.* 236 F.2d 159. The situation there presented involved the incorporation of a partnership pursuant to which the partnership assets were transferred to the new corporation in exchange for stock and notes. The note holders were partners in the transferor and were in control of the corporation immediately after the exchange. Unlike the sales contract here in question, which by reserving title to the assets in the transferors until the purchase price is paid gives them rights superior to those of other creditors, the notes issued to the transferor by the *Gooding Amusement Company* were subordinated to the claims of other creditors. Moreover, the majority of the notes there issued remained unpaid long after maturity, whereas the record herein discloses that substantial payments with interest have been made to J. I. Morgan by the corporation. In addition, we placed reliance on the failure of the taxpayers in *Gooding Amusement Company*, *supra*, to show that nontax consideration motivated the decision to accept the short-term judgment notes of the corporation in exchange for a portion of the assets transferred to it. We have described heretofore the business reasons motivating the execution of the installment sales contract here in issue. In *Gooding Amusement Company*, *supra*, we held that no gain or loss was recognized under the provisions of section 112(b)(5) of the 1939 Code on the ground that the notes received by the transferor in exchange for a portion of the

assets transferred to the corporation were actually evidence of equity capital. In our opinion, the situation here presented is factually distinguishable from the circumstances involved in Gooding Amusement Company, *supra*.

In view of the form of the contract here in issue, the reservation of title in the transferors until the full purchase price is paid, the business considerations underlying the execution of the installment sales contract, the superior position of the claims of J. I. Morgan to the claims of other corporate creditors, the contract provision requiring certain fixed payments to be made to the transferors without regard to corporate earnings, the absence of an agreement not to enforce collection, the provision requiring the payment of interest to J. I. Morgan at a reasonable rate, the fact that the contract price was equal to the fair market value of the assets transferred thereunder, and the substantial payments of principal and interest to J. I. Morgan under the contract convince us that the transaction which was completed on October 1, 1950, constituted a bona fide sale to the corporation rather than a contribution to corporate capital.

Under the installment sales contract, the corporation is liable for the payment of a fixed purchase price. It has made an investment in the logging equipment and is required under the contract to maintain the property, to keep it insured, and to bear the risk of loss. Thus, despite the fact that J. I. Morgan, Inc., does not hold legal title to the

property, the burden of depreciation falls upon it. E. J. Murray, 21 T.C. 1049. Consequently, under section 113(a) of the 1939 Code, the basis for depreciation of the assets, the right to possession and use of which were acquired by the corporation on October 1, 1950, is the cost of the assets to the corporation. In addition, the corporation is entitled to the deductions claimed by it for interest paid to the transferors pursuant to the installment sales contract during the fiscal years ended April 30, 1952, 1953, and 1954. We further hold that the amounts received by the transferors from the corporation during the years in issue as payments of principal and interest pursuant to the installment sales contract do not constitute a distribution of dividends.

Issue 5—Investment Certificate

Findings of Fact

On or about August 10, 1937, J. I. Morgan acquired an "Accumulative Investment Certificate," Series F-232668, from Investors Syndicate (presently known as Investors Diversified Services, Inc.) of Minneapolis, Minnesota. Under the terms of the certificate, the issuing company agreed to pay to Morgan (with certain options) at the expiration of 15 years, an amount in excess of his aggregate payments. On September 28, 1952, J. I. Morgan exercised one of the available options to extend the certificate for an additional period of not more than 10 years.

The following is a detailed statement of the foregoing "Accumulative Investment Certificate":

INVESTORS SYNDICATE

Minneapolis, Minnesota

Name Changed on 3-30-49 to: Investors Diversified Services, Inc.

Number—Series F232668

Dated 8-10-37.

Annual Advance Payment for 15 years \$ 600.00

Maturity in 15 years (option 13 elected 9-28-52 to continue not more than 10 years).

With optional settlement privileges.

Cash Value for each \$25.00 Maturity	Year	To	Cash Value end of year	Paid In	Excess of Cash Value over amounts Paid In		Yearly Increase
\$ 44	1		\$ 220	\$ 600			
134	2		670	1,200			
264	3		1,320	1,800			
400	4		2,000	2,400			
540	5		2,700	3,000			
700	6		3,500	3,600			
860	7		4,300	4,200			
1,024	8		5,120	4,800			
1,200	9		6,000	5,400			
1,418	10	8-10-47	7,090	6,000			
1,600	11	8-10-48	8,000	6,600			
1,810	12	8-10-49	9,050	7,200	\$1,850		
2,020	13	8-10-50	10,100	7,800	2,300	\$450	
2,240	14	8-10-51	11,200	8,400	2,800	500	
2,500	15	8-10-52	12,500	9,000	3,500	700	
2,724	16	8-10-53	13,620	9,600	4,020	520	
2,958	17	8-10-54	14,790	10,200	4,590	570	

Opinion

The respondent has determined that the annual increases in the excess of the cash value of an Investors Syndicate certificate over the amounts paid in represent interest taxable as ordinary income during the years of increase. The amounts determined by respondent to be taxable income to petitioners for the years 1950, 1951, 1952, 1953, and 1954 are \$450, \$500, \$700, \$520, and \$570, respectively.

Petitioners contend that the annual increment in the cash value of such a certificate is not properly taxable during the years of increase, but is taxable only upon retirement at maturity as capital gain under section 117(f) of the 1939 Code.²

An identical issue involving the same type of certificate issued by Investors Syndicate was presented in *George Peck Caulkins*, 1 T.C. 656, *affd.* 144 F.2d 482. We there held that the certificate owned by the taxpayer constituted an evidence of indebtedness within the meaning of section 117(f)

²Sec. 117. Capital Gains and Losses.

* * *

(f) Retirement of Bonds, etc.—For the purposes of this chapter, amounts received by the holder upon the retirement of bonds, debentures, notes, or certificates or other evidences of indebtedness issued by any corporation (including those issued by a government or political subdivision thereof), with interest coupons or in registered form, shall be considered as amounts received in exchange therefor.

of the 1939 Code, and that the annual increment in the cash value of the certificate should properly be reported as capital gain upon retirement at maturity. Our decision in that case is squarely in point here. We accordingly hold that under section 117(f) of the 1939 Code and section 1232(a)(1) of the 1954 Code, insofar as here applicable, the amounts in question are taxable to petitioners as capital gain at the maturity of the certificate, rather than as interest income during the years of increase.

Reviewed by the Court.

Decisions will be entered under Rule 50.

Murdock, J., dissenting:

I disagree with that part of this opinion in which it is held that the petitioner is entitled to depreciation on the depreciable assets acquired from the Morgans on October 1, 1950, based upon a "cost" of those assets equal to their fair market value on October 1, 1950, which is stated to be "the date of acquisition." The petitioner got possession of the assets at that time and began to use them in its business but it did not acquire the assets and was not to receive legal title to them until the purchase price was fully paid. The fact that this petitioner was to maintain the property, keep it insured and bear the risk of loss is no justification for giving it depreciation on the assets. These items are taken care of by deductions other than for depreciation.

However, it acquired an equitable interest in and is entitled to some depreciation on the assets. The Commissioner has allowed some depreciation and apparently does not seek to cut down on the amount allowed. Therefore, the Commissioner's determination on this point might be left undisturbed.

This petitioner took deductions for depreciation as follows:

1951	\$ 47,732.13
1952	174,846.57
1953	118,523.78
1954	180,943.54
	<hr/>
Total	\$522,046.02

The purpose of deductions for depreciation is to return to the taxpayer, tax free, the cost or basis to it of property being consumed or worn out in its business. The statute provides for the deduction of "a reasonable allowance" for depreciation.

The petitioner was to assume liabilities of Morgan in the amount of \$129,682.55, but the record does not show what, if anything, the petitioner ever did to discharge those obligations. It was to pay, in addition, \$500,000 in cash, but it paid only \$2,000 in 1950 and \$30,860 on December 31, 1953, on account of that cash purchase price up to the close of the taxable years. Later it paid a little more and then further payments were called off by the parties. Cf. Lloyd H. Redford, 28 T.C. 773. The deductions claimed by the petitioner, which deduc-

tions or substantial equivalents the opinion allows, would be far in excess of reasonable allowances for depreciation to this petitioner under the circumstances of this case.

If this case cannot be disposed of by making no change in the depreciation allowed by the Commissioner in determining the deficiency and a decision on the merits is necessary, then it seems to me that the petitioner is limited by its economic interest in the depreciable assets.

The Murray case cited and the cases relied on in the Murray case held that the taxpayer had either equitable or legal title to the property which was being depreciated. I know of no case which holds that a taxpayer could recover such amounts as this taxpayer is being allowed to recover where its actual investment in that property is but a small fraction of the depreciation deductions and, possibly, may never be increased.

Raum, J., agrees with this dissent.

Pierce, J., dissenting:

The situation herein presented is not one wherein the corporation acquired title to the machinery and equipment subject to a purchase money mortgage. Cf. *Crane v. Commissioner*, 333 U. S. 1. To the contrary, the agreement which the corporation executed merely gave it possession and use of the property, on the following terms:

It is expressly and specifically agreed that title to said property, or any part thereof, or any additions thereto or improvements thereon, shall not pass from the Sellers to the Purchasers until the entire purchase price shall have been paid in full, and that no right, title or interest, legal or equitable, in the property aforesaid, or any part thereof, shall vest in the Purchaser until the delivery of the deed and bill of sale by the Sellers, or until the payment of its purchase price in full, and at the times and in the manner herein provided.

Thus the agreement was merely a contract to purchase; and the corporation obtained no depreciable interest in the property.

In the alternative, if the agreement was sufficient to convey any interest in the property, the transaction was an exchange under section 112 (b)(5) of the 1939 Code, with a consequent carry-over of the transferor's basis. The \$10,000 of capital paid into the corporation was obviously an inadequate capitalization to permit "purchase" of the property. The corporation should be considered a "thin" corporation; and the transfer of the property to it should be considered a contribution of additional equity capital.

Atkins, J., agrees with this dissent.

Filed July 9, 1958.

Served July 9, 1958.

[Title of Tax Court and Cause.]

RESPONDENT'S COMPUTATION FOR
ENTRY OF DECISION

The attached computation is submitted, on behalf of the respondent, in compliance with the Court's opinion determining the issues in this proceeding. Said computation provides as follows:

(1) That there are deficiencies in income tax due from the petitioners for the taxable years 1950 and 1953 in the amounts of \$7.22 and \$410.78, respectively.

(2) That there are no deficiencies in income tax due from the petitioners for the taxable years 1951, 1952 and 1954 and that there are no overpayments for said taxable years.

The computation is submitted without prejudice to the respondent's right to contest the correctness of the decision entered herein by the Court pursuant to the statute in such cases made and provided.

/s/ ARCH M. CANTRALL,
Chief Counsel,
Internal Revenue Service.

Of Counsel:

MELVIN L. SEARS,
Regional Counsel,

JOHN D. PICCO,
Attorney, Internal Revenue Service.

Without prejudice to the right to appeal, it is agreed that the attached computation is in accordance with the opinion of the Tax Court in the above-entitled proceeding.

/s/ CHARLES P. DUFFY,
Counsel for Petitioners.

ARC-AP:SF
P:MBF

COMPUTATION STATEMENT

RULE 50

In re: J. I. and Frances Morgan
New Meadows, Idaho

Docket No. 61346

Income Tax		
Year		Deficiency
1950		\$ 7.22
1951		None
1952		None
1953		410.78
1954		None
	Total	<u>\$418.00</u>

The details supporting the above computation are set forth in the attached pages 2 to 14, inclusive.

Taxable Year Ended December 31, 1950
Schedule 1
Adjustments to Income

Net income disclosed by statutory notice of deficiency dated December 22, 1955 ..	\$33,373.04
Net income adjusted	30,990.11
	<u> </u>
Adjustment	\$ 2,382.93
	<u> </u>

Reduction:

(a) Dividends	\$2,000.00	
(b) Increase in cash value	450.00	
(c) Accrued interest	592.48	\$ 3,042.48

Addition:

(d) Capital gain	\$ 659.55	659.55
		<u>\$ 2,382.93</u>

Schedule 1-a
Explanation of Adjustments

- (a) The opinion of the Tax Court of the United States promulgated July 9, 1958 is that the transaction between the petitioner and J. I. Morgan, Inc. was a sale and the amount received in payment is not a dividend.
- (b) The annual increment in the cash value of an "Accumulative Investment Certificate" is not taxable as ordinary income.
- (c) The respondent conceded that accrued interest in the amount of \$592.48 was not includible in income.
- (d) Capital gain on installment payment of \$2,000.00 received from corporation as shown in Exhibit "A" attached.

Taxable Year Ended December 31, 1950

Schedule 2
Computation of Tax

Net income adjusted		\$30,990.11
Less: Personal exemptions		1,200.00
		<u>Income subject to tax</u>
		\$29,790.11
		<u>One-half of taxable income</u>
		\$14,895.06
Tentative tax on \$14,895.06.....		\$ 4,680.68
Tax reduction: 13% of \$ 400.00.....	\$ 52.00	
9% of 4,280.68.....	385.26	437.26
		<u>One-half of income tax</u>
		\$ 4,243.42

Tax liability		\$ 8,486.84
Liability disclosed by return—		
A/c No. 300027	\$4,998.52	
A/c No. 511782	3,481.10	8,479.62
		<hr/>
Deficiency		\$ 7.22
		<hr/> <hr/>

Schedule 2-a
Statement of Account

Liability		\$ 8,486.84
-----------------	--	-------------

Assessed:

Estimated Tax—

Credit from 1949—9105029	\$ 711.86	
ES No. 1005113	2,400.00	
Form 1285—9/13/56—511782	3,481.10	
Paid on return	1,886.66	8,479.62
		<hr/>
Deficiency in assessment		\$ 7.22
		<hr/>

Liability		\$ 8,486.84
-----------------	--	-------------

Paid: Credit from 1949	\$ 711.86	
June 12, 1950	700.00	
Sept. 1, 1950	700.00	
Feb. 1, 1951	1,000.00	
May 21, 1951	1,886.66	
Sept. 27, 1956	3,481.10	8,479.62
		<hr/>
Deficiency in payment		\$ 7.22
		<hr/> <hr/>

Taxable Year Ended December 31, 1951

Schedule 3

Adjustments to Net Income

Net income disclosed by statutory notice of deficiency dated December 22, 1955 ..	\$29,605.23
As adjusted	28,512.75
	<hr/>
Adjustment—reduction	\$ 1,092.48
	<hr/> <hr/>

Reduction:

(a) Increase in cash value	\$ 500.00	
(b) Accrued interest	592.48	\$ 1,092.48
		<u> </u>
		<u> </u>

Schedule 3-a

Explanation of Adjustments

- (a) The opinion of the Tax Court of the United States promulgated July 9, 1958 is that the annual increment in the cash value of an "Accumulated Investment Certificate" is not taxable as ordinary income.
- (b) The respondent conceded that accrued interest in the amount of \$592.48 was not includible in income.

Schedule 4

Computation of Tax

Net income adjusted		\$28,512.75
Less: Personal exemptions		1,200.00
		<u> </u>
Income subject to tax		\$27,312.75
		<u> </u>
Income tax liability		\$ 8,376.48
Liability disclosed by return—		
A/c No. BR-300	\$6,744.24	
Assessment 9/13/56—511783	1,632.24	8,376.48
		<u> </u>
Overassessment/Deficiency		None
		<u> </u>
		<u> </u>

Taxable Year Ended December 31, 1951

Schedule 4-a

Statement of Account

Liability		\$ 8,376.48
Assessed:		
Estimated tax paid—1003255..	\$7,500.00	
Amount refunded—BR-300	755.76	\$6,744.24
		<u> </u>
Assessment—511783 9/28/56 ..	1,632.24	8,376.48
		<u> </u>
Deficiency to be assessed ..		None
		<u> </u>
		<u> </u>

Liability		\$ 8,376.48	
Paid: Estimated tax paid—			
3/20/51	\$ 500.00		
6/20/51	500.00		
9/19/51	500.00		
1/25/52	6,000.00	\$7,500.00	
Amount refunded		(755.76)	
Additional assessment—			
9/27/56		1,632.24	8,376.48
Deficiency in payment			None

Taxable Year Ended December 31, 1952
Schedule 5
Adjustments to Net Income

Net income disclosed by statutory notice of deficiency dated December 22, 1955..	\$47,017.32
As adjusted	33,694.39
	<hr/>
Adjustment — reduction	\$13,322.93
	<hr/> <hr/>
Reduction:	
(a) Increase in cash value	\$ 700.00
(b) Accrued interest	592.47
(c) Rental income	12,030.46
	<hr/> <hr/>

Taxable Year Ended Deember 31, 1952
Schedule 5-a
Explanation of Adjustments

- (a) The opinion of the Tax Court of the United States promulgated July 9, 1958, is that the annual increment in the cash value of an "Accumulated Investment Certificate" is not taxable as ordinary income.
- (b) The respondent conceded that accrued interest in the amount of \$592.48 was not includible in income.
- (c) The respondent abandoned the position that this amount was a taxable dividend to the petitioners.

Schedule 6
Computation of Tax

Net income adjusted		\$33,694.39
Less: Personal exemptions		1,200.00

Income subject to tax		\$32,494.39

Income tax liability		\$11,908.86
Liability disclosed by return—		
A/c No. AF(7) 205	\$9,769.90	
23c—9/28/56—511784	2,138.96	\$11,908.86

Deficiency		None

Taxable Year Ended December 31, 1952

Schedule 6-a

Statement of Account

Liability		\$11,908.86
Assessed:		
Estimated Tax—EP 6194	\$6,500.00	
AF-7-205	1,844.90	
511784	2,138.96	
Withheld tax	1,425.00	11,908.86

Deficiency to be assessed		None

Liability		\$11,908.86
Paid: Mar. 31, 1952	\$ 500.00	
June 19, 1952	500.00	
Sept. 18, 1952	500.00	
Jan. 26, 1953	5,000.00	
July 21, 1953	1,844.90	
Sept. 27, 1956	2,138.96	
Withheld tax	1,425.00	11,908.86

Deficiency in payment		None

Taxable Year Ended December 31, 1953
Schedule 7

Adjustments to Net Income

Net income disclosed by statutory notice of deficiency dated December 22, 1955		\$64,471.50
As adjusted		42,675.85
		<hr/>
Adjustment—reduction		\$21,795.65
		<hr/> <hr/>
Reduction:		
(a) Dividends	\$30,860.00	
(b) Increase in cash value	520.00	
(c) Accrued interest	592.47	\$31,972.47
		<hr/>
Addition:		
(d) Capital gain	\$10,176.82	10,176.82
		<hr/>
Total Adjustment Reduction		\$21,795.65
		<hr/> <hr/>

Taxable Year Ended December 31, 1953
Schedule 7-a

Explanation of Adjustments

- (a) The opinion of the Tax Court of the United States promulgated July 9, 1958, is that the transaction between the petitioner and J. I. Morgan, Inc., was a sale and the amount received in payment is not a dividend.
- (b) The opinion of the Tax Court of the United States promulgated July 9, 1958, is that the annual increment in the cash value of an "Accumulated Investment Certificate" is not taxable as ordinary income.
- (c) The respondent conceded that accrued interest in the amount of \$592.47 was not includible in income.
- (d) Capital gain on installment payment of \$30,860.00 received from corporation, as shown in Exhibit "A" attached.

Schedule 8
Computation of Alternative Tax

Net income adjusted		\$42,675.85
Less: Personal exemptions		1,200.00
		\$41,475.85
Enter one-half		\$20,737.92
One-half of long-term capital gain.....		5,088.41
		\$15,649.51
Balance		5,630.24
Tax on \$15,649.51		\$11,260.48
Multiply by two		5,291.94
Plus: 52% of \$5,088.41 \times 2.....		\$16,552.42
Tax liability—joint return		\$16,552.42
Liability disclosed by return		
A/e No. OR 1005232	\$14,925.62	
23c—9/28/56—511785	1,216.02	16,141.64
		\$ 410.78
Deficiency		\$ 410.78

Taxable Year Ended December 31, 1953

Schedule 8-a

Statement of Account

Liability		\$16,552.42
Assessed:		
EP 4445	\$13,000.00	
Withheld tax	2,220.60	
OR 1005232	(294.98)	
511785	1,216.02	16,141.64
		\$ 410.78
Deficiency to be assessed		\$ 410.78

Liability		\$16,552.42
Paid: Mar. 20, 1953	\$ 1,000.00	
June 26, 1953	1,000.00	
Sept. 18, 1953	1,000.00	
Jan. 19, 1954	10,000.00	
Withheld tax	2,220.60	
Sept. 2, 1954	(294.98)	
Sept. 27, 1956	1,216.02	16,141.64
	<hr/>	<hr/>
Deficiency in payment		\$ 410.78
		<hr/> <hr/>

Taxable Year Ended December 31, 1954

Schedule 9

Adjustments to Net Income

Net income disclosed by statutory notice of deficiency dated December 22, 1955 ..		\$32,069.97
As adjusted		23,409.38
		<hr/>
Adjustment — reduction		\$ 8,660.59
		<hr/> <hr/>

Reduction:

(a) Dividend	\$20,514.27	
(b) Increase in cash value	570.00	
(c) Accrued interest	592.47	\$21,676.74
	<hr/>	<hr/>

Addition:

(d) Capital gain	\$ 3,738.53	
(e) Interest income	9,277.62	13,016.15
	<hr/>	<hr/>
Total Adjustment Reduction		\$ 8,660.59
		<hr/> <hr/>

Taxable Year Ended December 31, 1954

Schedule 9-a

Explanation of Adjustments

- (a) The opinion of the Tax Court of the United States promulgated July 9, 1958 is that the transaction between the petitioner and *J. I. Morgan, Inc.* was a sale and the amount received in payment is not a dividend.

- (b) The opinion of the Tax Court of the United States promulgated July 9, 1958 is that the annual increment in the cash value of an "Accumulated Investment Certificate" is not taxable as ordinary income.
- (c) The respondent conceded that accrued interest in the amount of \$592.47 was not includible in income.
- (d) Capital gain on installment payment of \$11,336.65 received from corporation as shown in Exhibit "A" attached.
- (e) Interest income reported on the return was classified as a dividend in the statutory notice of deficiency, and it is included in income here as interest income.

Taxable Year Ended December 31, 1954

Schedule 10

Computation of Tax

Net income adjusted		\$23,409.38
Less: Personal exemptions		1,200.00
		<hr/>
Taxable income		\$22,209.38
		<hr/>
Tax liability—joint return		\$ 6,119.56
Liability disclosed by return—		
A/c No. BF-5-100011	\$ 6,163.54	
23c — 9/28/56 — 511786	3.72	6,167.26
		<hr/>
Overassessment		\$ 47.70
Reduced (See paragraph below)		47.70
		<hr/>
Deficiency/Overassessment		None

There is no evidence of record that payments made by the petitioners were in excess of \$6,119.56, the tax liability shown above. Accordingly there is no deficiency and no overpayment for the taxable year ended December 31, 1954.

INSTALLMENT SALE OF CAPITAL ASSETS
TO J. I. MORGAN, INC.

Contract receivable from corporation	\$500,000.00
Add: Liabilities assumed by corporation	129,682.55
	<hr/>
Total selling price	\$629,682.55
Total basis of all assets sold—(explained below)	214,377.00
	<hr/>
Gain on sale	\$415,305.55
	<hr/> <hr/>
Gain on sale: $415,305.55/629,682.55 = 65.95475\%$	

COMPUTATION OF ADJUSTED
BASIS OF ALL ASSETS SOLD

Depreciable Assets	Assets	Reserve for Depreciation
Dec. 31, 1948 Balances per prior Revenue Agent's Report	\$317,619.66	\$139,532.22
1949 Additions for year	16,542.10	56,365.06
	<hr/>	<hr/>
Totals	\$334,161.76	\$195,897.28
Dispositions during year..	(4,584.00)	(4,069.00)
	<hr/>	<hr/>
Dec. 31, 1949 Balances per returns filed	\$329,577.76	\$191,828.28
1950 Additions to Sept. 30, 1950:	41,018.66	32,348.22
Garden Valley Roads in process of completion Cost 1-1-50 to 9-30-50	27,432.96	
Bunk and cookhouses in process of completion Cost 1-1-50 to 9-30-50	11,970.67	
	<hr/>	<hr/>
Totals	\$410,000.05	\$224,176.50
Dispositions 1-1-50 to 9-30-50	(7,282.66)	(4,042.91)
	<hr/>	<hr/>

Sept. 30, 1950 Basis of Assets	\$402,717.39	\$220,133.59
Less equipment transferred to J. I. Morgan, Inc. on Apr. 25, 1952	(10,414.35)	(5,465.24)
	<hr/>	<hr/>
Sept. 30, 1950 Balances	\$392,303.04	\$214,668.35
		<hr/> <hr/>
Less reserve for depreciation	214,668.35	
	<hr/>	
ADJUSTED BASIS OF DEPRECIABLE ASSETS SOLD	\$177,634.69	
Other assets sold to corporation 10-1-50:		
Cash in payroll account ..	12,500.00	
Inventories Logs	1,000.00	
Inventories: Warehouse ..	23,242.31	
	<hr/>	
TOTAL TAX BASIS OF ALL ASSETS SOLD	\$214,377.00	
	<hr/> <hr/>	

AMOUNT TO BE INCLUDED IN INCOME

Year	Installment Paid	Percentage of Profit	Capital Gain at 50%
1950	\$ 2,000.00	\$ 1,319.10	\$ 659.55
1953	30,860.00	20,353.64	10,176.82
1954	11,336.65	7,477.06	3,738.53

Received and filed September 18, 1958, T.C.U.S.

In the United States Court of Appeals for the
Ninth Circuit

T. C. Docket No. 61346

COMMISSIONER OF INTERNAL REVENUE,

Petitioner on Review,

vs.

J. I. MORGAN and FRANCES MORGAN,

Respondents on Review.

PETITION FOR REVIEW

To the Honorable Judges of the United States
Court of Appeals for the Ninth Circuit:

The Commissioner of Internal Revenue petitions the United States Court of Appeals for the Ninth Circuit to review the decision of the Tax Court of the United States entered in the above case on September 23, 1958, pursuant to its opinion filed July 9, 1958 (30 T. C., No. 89), in the consolidated causes of J. I. Morgan, Inc. vs. Commissioner of Internal Revenue, and J. I. Morgan and Frances Morgan, T. C. Docket Nos. 61345, 61346, ordering and deciding:

“That there are deficiencies in income tax for the taxable years 1950 and 1953 in the amounts of \$7.22 and \$410.78, respectively; and that there are no deficiencies due from, or overpayments due to, these petitioners in income tax for the taxable years 1951, 1952 and 1954.”

This petition for review is taken and filed pursuant to the provisions of Sections 7482 and 7483 and other applicable sections of the Internal Revenue Code of 1954, as amended.

Jurisdiction

The petitioner on review is the duly appointed Commissioner of Internal Revenue of the United States, and the respondents on review, J. I. Morgan and Frances Morgan, husband and wife, residing at New Meadows, Idaho, filed their joint federal individual income tax returns for the taxable years ended December 31, 1950; December 31, 1951; December 31, 1952; December 31, 1953, and December 31, 1954, the years involved herein, with the Collector of Internal Revenue and/or the District Director of Internal Revenue for the District of Idaho, whose office is located at Boise, Idaho, which collection district is within the jurisdiction of the United States Court of Appeals for the Ninth Circuit, wherein this review is sought.

Nature of Controversy

This case involves deficiencies in federal income tax for the years 1950, 1951, 1952, 1953 and 1954.

The primary question submitted for review herein is:

Did the Tax Court properly hold that the annual increment in the cash value of an "accumulative investment certificate," owned by the respondents on review, who kept their books of account and filed

their income tax returns on the accrual basis, was not taxable as ordinary income during the years of the annual increments, but such increment was taxable only as capital gain upon retirement at maturity?

The respondents on review kept their books of account and filed their federal income tax returns on the accrual basis.

On or about August 10, 1937, J. I. Morgan acquired an "Accumulative Investment Certificate," Series F-232668, from Investors Syndicate (presently known as Investors Diversified Services, Inc.), of Minneapolis, Minnesota. Under the terms of the certificate, the issuing company agreed to pay to Morgan (with certain options) at the expiration of 15 years, an amount in excess of his aggregate payments. On September 28, 1952, J. I. Morgan exercised one of the available options to extend the certificate for an additional period of not more than 10 years.

The following is a detailed statement of the foregoing "Accumulative Investment Certificate":

Investors Syndicate
Minneapolis, Minnesota

Name Changed on 3-30-49 to: Investors Diversified Services, Inc.

Number—Series F232668

Dated 8-10-37

Annual Advance Payment for 15 years \$600.00

Maturity in 15 years

(Option 13 elected 9-28-52 to continue not more than 10 years)

With optional settlement privileges.

Cash Value for each \$25.00					Excess of Cash Value over amounts Paid In	Yearly Increase
Maturity	Year	To	Cash Value end of year	Paid In		
\$ 44	1		\$ 220	\$ 600		
134	2		670	1,200		
264	3		1,320	1,800		
400	4		2,000	2,400		
540	5		2,700	3,000		
700	6		3,500	3,600		
860	7		4,300	4,200		
1,024	8		5,120	4,800		
1,200	9		6,000	5,400		
1,418	10	8-10-47	7,090	6,000		
1,600	11	8-10-48	8,000	6,600		
1,810	12	8-10-49	9,050	7,200	\$ 1,850	
2,020	13	8-10-50	10,100	7,800	2,300	\$ 450
2,240	14	8-10-51	11,200	8,400	2,800	500
2,500	15	8-10-52	12,500	9,000	3,500	700
2,724	16	8-10-53	13,620	9,600	4,020	520
2,958	17	8-10-54	14,790	10,200	4,590	570

Since the respondents reported their income on the accrual basis, the Commissioner determined that the annual increases in the excess of the cash value over the amounts paid in represented interest taxable as ordinary income during each of the respective years of increase. Such action was consistent with uniform practice of the Internal Revenue Service with regard to bonds issued on a discount basis and held by an accrual basis taxpayer.

(See: Revenue Ruling 55-136; Revenue Ruling 56-299, 1956, 1 C.B. 603. C.B. 1955-1, 213-215; S.M. 3820, C.B. IV-2, 32; also G.C.M. 15875 C.B. XIV-2, 100.)

It is the position of the Commissioner, as set forth in the above rulings, that the amount received

upon the redemption of a bond or other evidence of indebtedness which represents original or initial discount constitutes "interest" which is taxable as ordinary income, and that it was never intended by Congress that it be treated otherwise.

The Commissioner accordingly determined that the annual increases in the excess of the cash value of an Investors Syndicate certificate over the amounts paid in represent interest taxable as ordinary income during the years of increase; the amounts thus determined to be taxable income to respondents for the years 1950, 1951, 1952, 1953 and 1954 are \$450, \$500, \$700, \$520 and \$570, respectively.

Respondents contend that the annual increment in the cash value of such a certificate is not properly taxable during the years of increase, but is taxable only upon retirement at maturity as capital gain under Section 117(f) of the 1939 Code, which provides:

Sec. 117. Capital Gains and Losses.

(f) Retirement of Bonds, Etc.—For the purposes of this chapter, amounts received by the holder upon the retirement of bonds, debentures, notes, or certificates or other evidences of indebtedness issued by any corporation (including those issued by a government or political subdivision thereof), with interest coupons or in registered form, shall be considered as amounts received in exchange therefor.

Citing and relying on its prior decision in *George Peck Caulkins vs. Commissioner* (1943) 1 T.C. 656, aff'd. (C.A. 6, 1944), 144 F. 2d 482, Tax Court accordingly held that under Section 117(f) of the 1939 Code and Section 1232(a) of the 1954 Code, insofar as here applicable, the amounts in question are taxable to the respondents on review as capital gain at the maturity of the certificates, rather than as interest income during the years of increase.

In the cited case, a retirement at maturity of an investment certificate issued at a discount, held by a cash basis taxpayer, was held to fall within Section 117(f). Here there was no retirement and the respondents were on the accrual basis and they continued to hold the certificates. It is, therefore, submitted that the decision of the Tax Court is erroneous and should be reviewed since it contravenes two clearly defined principles: (1) That the amounts paid to a bond or certificate holder by reason of his holding the obligation for a period of time are in the nature of interest and are taxable as such; and (2) that accrual basis taxpayers are taxable upon the annual increment in value of obligations where such increment presents an interest factor.

Statement of Points to Be Relied Upon

The following statement of points are to be relied upon herein:

1. In failing to hold and decide that the annual increment in the cash value of the certificate in-

volved herein is taxable to the respondents on review as ordinary income under Section 22(a) of the Internal Revenue Code of 1939 and Section 61(a) of the Internal Revenue Code of 1954, where applicable.

2. In holding and deciding that the annual increment in the cash value of the certificate involved herein is taxable to the respondents on review as capital gain at the maturity of the certificate under the provisions of Section 117(f) of the Internal Revenue Code of 1939 and Section 1232(a)(1) of the Internal Revenue Code of 1954, insofar as here applicable.

3. In holding and deciding that this case is controlled by its prior decision in the case of *George Peck Caulkins vs. Commissioner* (1943) 1 T.C. 656, *aff'd.* (C.A. 6, 1944), 144 F. 2d. 482.

4. In failing to hold and decide that the *Caulkins* case was erroneously decided or it is at least distinguishable on its facts.

5. In ordering and deciding that there are deficiencies in income tax for the years 1950 and 1953 only in the respective amounts of \$7.22 and \$410.78, and that there are no deficiencies in income tax for the years 1951, 1952 and 1954.

6. In that its opinion and decision are contrary to the revenue statutes and regulations promulgated thereunder and are not supported by the evidence of record.

Wherefore it is prayed that this petition for review be reviewed and the errors complained of herein be corrected, and the case remanded to the Tax Court of the United States for such purpose.

/s/ CHARLES K. RICE,
Assistant Attorney General,

/s/ ARCH M. CANTRALL,
Chief Counsel, Internal Revenue Service, Counsel
for Commissioner of Internal Revenue.

Filed December 11, 1958, T.C.U.S.

[Title of Tax Court and Cause.]

CERTIFICATE

I, Howard P. Locke, Clerk of the Tax Court of the United States, do hereby certify that the foregoing documents, 1 to 13, inclusive, constitute and are all of the original papers on file in my office as called for by the "Designation," including Exhibits 7-G through 11-K, L, M, and 23, in the case before the Tax Court of the United States docketed at the above number and in which the respondent in the Tax Court has filed a petition for review as above numbered and entitled, together with a true copy of the docket entries in said Tax Court case, as the same appear in the official docket in my office.

[Title of Court of Appeals and Cause.]

No. 16395

PETITIONER'S STATEMENT OF POINTS
AND DESIGNATION OF THE RECORD
FOR PRINTING

Pursuant to Rule 17.6 of the Rules of this Court, petitioner hereby states that it intends to rely upon the following points on this appeal:

1. The Tax Court erred in holding that the annual increments during the tax years in the cash value of an "Accumulative Investment Certificate," owned by the taxpayer-husband, was taxable as capital gain upon retirement of the "Certificate" at maturity, under Section 117(f) of the Internal Revenue Code of 1939.

2. The Tax Court erred in failing to hold that the annual increments in cash value of the "Certificate" were taxable in the years of increment as interest income to the taxpayers, who kept their books and filed their income tax returns on the accrual basis.

Petitioner hereby designates for printing, as material to the consideration of this appeal, the following portions of the record.

Docket entries.

Findings of fact and opinion.

Agreed computation.

Decision.

Petition for review.

/s/ CHARLES K. RICE,
Assistant Attorney General, Attorney for the Com-
missioner.

Certificate of Service attached.

[Endorsed]: Filed March 12, 1959.